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OPTIMIZING THE BENEFITS OF FOREIGN DIRECT INVESTMENT (FDI) INTO UGANDA: THE CASE FOR REGULATION OR SUPERVISION

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ABSTRACT

This study investigated the effects of regulation or supervision on investments, particularly in the financial sector in Uganda, since the enactment of the Investment Code Act in 1991, and the subsequent establishment of the Uganda Investment Authority (UIA) as provided under the Act. It used mostly secondary data and interviews on investments facilitation in Uganda. The Research Design was ex post facto, and the Analysis qualitative. The findings showed that in Uganda, there was a strong supervision of the financial system; the financial institutions were always highly capitalized; the financial sector was dominated by foreign operators; and the rural areas were grossly under-banked. Also, there existed a curious relationship between the financial services phenomenal growth and an equally matched growth in investment in Uganda since 2005/2006 following the lifting of the moratorium on the licensing of new commercial banks in the country. Quite significantly, while Uganda Investment Authority (UIA) had impressive records in attracting investments into the country, it made no concrete efforts to supervise or regulate these investments once they were licensed and established. This was contrary to Section 6(a) of the Investment Code Act, 1991, which authorized the Authority not only to promote and facilitate, but also to supervise investments in Uganda. Rather, UIA seemed to have abandoned the supervisory aspects of its statutory responsibilities almost entirely to the sectoral regulators, such as Bank of Uganda (BoU) for the banking, Insurance Regulatory Authority (IRA) for insurance, Capital Markets Authority (CMA) for the capital market, and Uganda Communication Commission (UCC) for communication.

In order for Uganda to optimize the benefits of investments, it was recommended that the investments should be effectively supervised by Uganda Investment Authority in addition to, and as a safeguard to the failures of, sectoral regulation. It was further recommended that there should be deliberate efforts to stimulate local investment in the banking industry so as to restore a measure of local control to this important engine of economic growth which was discovered to be under the near complete dominance of foreign investors. The adoption of a rural banking scheme was also recommended in order to enhance financial penetration into the rural areas of Uganda.

The curious relationship that was discovered to exist between the phenomenal growth in financial services and an equally matched increase in investment in Uganda in 2005/06 following the lifting of the moratorium on the licensing of new commercial banks in the country, led to the suspicion that a relationship existed between regulation and foreign direct investment flow into Uganda that calls for quantitative analysis. This was suggested as an area for future research.

KEYWORDS: ***Investment Regulation or Supervision, Foreign Direct Investment, Trans-National Companies, Mergers and Acquisition, Greenfield Investment.***

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INTRODUCTION

Background to the Study

Economies, especially the developing ones, are increasingly looking beyond their national frontiers in the bid to boost investment and accelerate economic growth. This is due mainly to the constraints in their local resource bases, and the clamor by citizens for improved standards of living. Until very recently, western donors have praised Uganda's record on macroeconomic stability, with its average 6 percent annual economic growth in the past 20 years, relatively low inflation and stable currency, as favourable for foreign direct investment into the country (The New Vision, January 9, 2009).

Foreign Direct Investment (FDI) is a major source of capital inflows into the domestic economies. Consequently, countries position themselves as the conducive destinations for foreign investments. They embark on the promotion and facilitation of foreign investment inflows into their economies. While investment promotion is meant to attract foreign investments which usually result from the activities of Trans-National Companies (TNCs), investment facilitation attempts to ease the costs and burden of doing business for the investors, with the hope of retaining their investments and possibly getting increasing shares of their investment wallets. Investment regulation or supervision, on the other hand, ensures that the benefits of the foreign investments to the domestic economies are optimized.

Ideally the purpose of investment is to benefit both the investing entity and the host economy. While the promotion and facilitation of investments usually benefit the foreign direct investors, the local economy can only optimize the benefits resulting from the operations of the FDI through the effective regulation or supervision of such investments. It is possible for FDI to be attracted into and facilitated in an economy, only for the economy not to benefit from such activities. This is more likely to occur if the avenue for the investment inflow was Merger and Acquisition (M&A), as against Greenfield investment. M&A FDI involves just a transfer of ownership, thereby transforming the firm from local to foreign; while Greenfield FDI involves mainly the creation of new assets in the host economy. As observed by Ntwala (2003), M&As raise particular concerns for developing countries, such as the extent to which they bring new resources to the economy, the denationalization of domestic firms, employment reduction, loss of technological assets, and increased market concentration with implications for the restriction of competition. Thus, M&As may result in profits for the investing firms, while destroying the domestic industries.

The studies of the United Nations Conference on Trade and Development (UNCTAD) for the World Investment Report 2000 revealed that, for the host country, the benefits of M&As were lower and the risks of negative effects were greater when compared to Greenfield investments, especially at the time of entry over the short term. The UNCTAD research on M&As, therefore, concluded on five issues. First, that FDI through M&As corresponded to a smaller productive investment than Greenfield as the financial resources did not necessarily go into increasing the capital stock. Secondly, M&As were less likely to transfer new or better technologies than Greenfield investment FDI. Third, FDI through M&As did not generate employment at the time of entry into the host economy, and might lead to lay-offs as the acquired firms are restructured. Fourthly, FDI through M&As could reduce competition, and might even be used deliberately to eliminate competition. And lastly, over the longer term, cross-border M&As were often followed by sequential investment that did increase the capital stock. Evidence showed that in some cases, foreign investors entered a market solely with the purpose of closing down domestic competitors and establishing a monopoly in the economy. However, the most noteworthy policy mechanism against such practices and which also served to protect the domestic

economy was a competition policy (Ntwala, 2003).

Since the commencement of the deregulation of the Ugandan economy in the late 1980s, the country has had an impressive record of attracting foreign investments. Also, the discovery of oil in the Albertine region had heightened investor interests in the country. Uganda had continued to attract investors, with 4,190 projects licensed since the investment authority was set up in 1991, up to 2010; with an accumulated planned investment up to 2009 of $12b, and over 440,000 jobs created. However, the same could not be said for the facilitation of foreign investments in Uganda. Despite the attractive investment prospects in the country and the entire East African Community (EAC) region, non-tariff barriers (NTBs) like the poor state of infrastructure and power shortages still hampered trade and investment. The absence of a robust railway network undermined trade and investment in the region's bulky resources that included agricultural products and minerals. The roads linking the region were in sorry states, thus, pushing up the cost of doing business in the entire EAC (The New Vision Newspaper, 10th May, 2010). The situation was even worse for regulation or supervision of investments in Uganda, where no effective mechanism exists for such, except at the sectoral levels.

Thus, if the local economy were to optimize the benefits of FDI, mechanisms must be emplaced for the over-all effective supervision and regulation of the activities of the investors, in addition to, and as a safeguard to the failures of, sectoral regulation; otherwise, the fears expressed about M&A investments were likely to materialize in Uganda. It was for this reason that the Investment Code Act, 1991, under Section 6(a) required the Uganda Investment Authority (UIA), not only to promote and facilitate, but also to supervise investments in Uganda. The effectiveness of UIA in supervising investments in Uganda was left to be determined.

INVESTMENT REGULATION OR SUPERVISION

Definition of Regulation

Regulation or Supervision is the application of rules designed to control the conducts of those to whom they apply. Regulation also is the official rules which must be complied with. It is a set of rules, principles, or conditions that governs procedure or behavior (Collins English Dictionary, 2009). Thus, it entails both the rules and the enforcement of those rules. In contemporary times, it is said to involve the imposition of rules by a government, backed by the use of penalties and the authority of the state, and intended to change the behavior of individuals or groups to which the rules apply. A broader definition of regulation includes any technique or approach designed to control, alter or influence behavior (Nielsen**,** *2004*).

Regulation or Supervision of businesses had always existed in the world in one form or the other. It was in being in the early Egyptian, Indian, Greek, and Roman civilizations. Standardized weights and measures were used to some extent, and gold may have operated to some degree as an international currency. In China, a national currency system existed before the paper currency was invented. Sophisticated laws on weights and measures operated in Ancient Rome. In the Early Middle Ages in Europe, regulation continued to exist in the forms of norms, customs, and privileges, even after laws, standardization, and the power of the state weakened with the decline of Rome. This was helped by the unified Christian identity and respect for contracts (Braithwaite and Peter, 2000; Steyn, 2011).

Regulation or supervision is designed to make the system work more efficiently. It is, thus, predicated on the dissatisfaction with the status quo, and the need for improvement; the so-called mischief rule in interpretation of laws.

Types of Regulation

There are different classifications of regulation. However, only three of such classifications are examined hereunder.

Bound (2009) classified regulation into four different types: Arbitrary Regulations, Good faith Regulations, Goal conflict Regulations, and Process Regulations. Arbitrary regulations were standards or rules mandating the use of one out of several equally valid options. An example was the choice to drive on the left or right hand side of the road. Although it made no practical difference which side was chosen, it *was* important that all people adhered to the common choice. Good faith regulations, on the other hand, were those which established baselines of behavior in certain areas. For example, health regulations for restaurants existed to protect consumers and minimize food poisoning risks. In these scenarios, no responsible party would object to the stated goals of the regulations, but arguments might arise over the complexities of the regulations and the difficulties of compliance. These types of regulations also provided benchmarks that could be used to prove *bona fide* intent to other parties. Another type of regulation, the goal conflict regulations, normally recognized the intrinsic conflicts between two goals -- typically the goal of an individual and the goal of society -- and regulated for the greater good of the society. Examples of goal conflict regulations were those mandating the wearing of seatbelts and placing limits on alcohol consumption when driving. The last type of regulation, process regulations, dictated how tasks should be accomplished, and not just the outcomes that were either prescribed or proscribed. This was the riskiest type of regulation since it sacrificed innovation and agility for ensuring less variability in process delivery. These were rare in the public sector, but were very common in the private sector due to the often misguided drive for the adoption of "best practices". Call centre scripts were a common example of process regulations.

According to Bound (2009), regulation could also be classified according to the nature of the regulator, ie the entity responsible for enforcing the regulations. This had given rise to three types of regulation: Peer Regulation, Fiat Regulation, and Statutory Regulation. Peer Regulations were the regulations that were self-imposed and self-policed by the communities or operators. Fiat Regulations were regulations that were unilaterally imposed and enforced by those with the power to do so. Statutory Regulations, on the other hand, occurred where the imposition and enforcement of the regulations were delegated to independent third-party authorities.

Regulations could also be classified according to the activities of the economy, polity, society, etc, to which they apply. In this sense, we will have Investment Regulation, Financial Regulation, Political Parties Regulations, Sports Regulation, etc. Of particular importance to this study were investment regulation and financial regulation.

Investment Regulation

Regulation involves the enactment and implementation of laws by the government to control certain activities; often restricting some business or other actions. Deregulation, on the contrary, involves the removal of restrictions and granting of greater freedom and discretion to businesses or others by the government.. The purpose of the regulatory laws may be to protect the public from unethical or dangerous business or other activities or practices. On the other hand, deregulatory laws may be enacted because regulations may have been seen as harmful to businesses or competition or other activities. An example of deregulation in the U.S. is the Energy Policy Act of 1992 which removed restrictions on American electricity companies in an attempt to boost competition. Deregulation can be problematic in that it has the potential to create disruptions in the market and harm consumers. For example, Tom Allison, a counsel to the U.S. Senate

Commerce Committee, has argued that deregulation of the American airline industry has led to disruptions and increased costs (Abraham, 2011). In Uganda, examples of deregulation abound in the financial system, such as the interest rate and exchange rate liberalization, while those of regulation are seen in the numerous guidelines and instruments with which the Bank of Uganda (BoU) supervises the banking industry.

Specifically, investment regulation refers to actions taken by governments, and designed to police or control certain investment activities in the economy or part of it, for the greater benefit of the whole economy. It differs from the regulations in the various sectors of the economy which are restricted to the activities in those sectors. The example of investment regulation in Uganda is the role envisaged for UIA under section 6(a) of the Investment Code Act, 1991, while the examples of sectoral regulation are yet seen in the control of the banking industry by BOU.

Financial Regulation

Financial regulation is a form of sectoral regulation or supervision, which subjects financial institutions to certain requirements, restrictions and guidelines, aiming to maintain the integrity of the financial system. It may be handled by a government or a non-governmental organization. The specific aims of financial regulation usually include the enforcement of applicable laws, prevention of cases of market manipulation such as insider trading, ensuring competence of providers of financial services, the protection of clients and investigation of complaints, the maintenance of confidence in the financial system, and the reduction of violations of laws and regulations.

Long and Vittas (1991) had suggested three criteria for use in evaluating financial regulation and structure to include Stability, Efficiency, and Fairness. As a result of massive losses suffered by financial institutions during the last world economic melt-down, stability had become of significant importance. It could be enhanced by increasing the capital requirements of financial institutions, and strengthening financial supervision. In developing countries there was the growing concentration and a spread of universal banking, suggesting economies of both scale and scope. Available evidence suggested that concentrated banking systems tended to have lower margins and operating costs as well as higher profits. However, large banks tended to be inefficient. Their sizes were usually the result of controls and restrictions on competition and entry rather than superior efficiency. Protecting users of financial systems from the abusive behavior of the financial institutions, creating equality in the competition between banking institutions, and tackling the problems caused by potential conflicts of interest were the “fairness” criteria. According to these authors, there were tradeoffs between these three criteria, and the answers to the conflicts ought to be sought on a country-by-country basis.

As a private think tank economic and financial adviser to policy makers, Re-Define (2011), had argued that the 2009 financial and economic crisis was due to the outdated model of regulation where governments tried in vain to regulate a global financial industry with a nationally focused and highly fragmented regulatory system. Consequently, large swathes of the financial industry hid in the ‘regulatory cracks’ and were unsupervised. This weakness in supervision was reinforced by an ideologically driven deregulation based on a misplaced faith in the ability of markets to always self correct. Furthermore, even when regulations existed, they were not applied. It was in this poorly regulated ‘shadow financial system’ comprising hedge funds and other off balance sheet exposures that the crisis originated and its intensity was reinforced by the risks hidden in ‘shadow financial products’ such as Credit Default Swaps which were also unregulated. In order to restore faith in the financial system and to ensure that a crisis of this magnitude did not recur, it was imperative to strengthen regulations and expand their scope. All financial activity that could potentially pose a danger to the stability of the financial system and hence have a disruptive effect on the economy must be regulated and supervised.

Particularly, and as a panacea to such crisis, Re-Design (2011) suggested Comprehensive Regulation; Regulating Substance, not Form; Maintaining Global Regulatory Floor; and Having Special and Differential Regulation for the Less Developed Countries (LDCs). First, regulation should be comprehensive in scope so that there was a presumption to regulate all financial institutions, all financial products and all jurisdictions to fill up the 'regulatory cracks' where risks might be hidden from view. Second, regulatory and supervisory coverage should follow the principle of economic substance and function, not legal form. Thus, and practically speaking, if something 'walks like a duck and talks like a duck, it should be treated as a duck' and not something else.. Third, the European Union (EU) should focus its financial diplomacy efforts on pushing for a high 'global regulatory floor' that would apply to all jurisdictions including offshore financial centers. This push should be supported by legislation that discriminated against lower regulatory standards by withholding access to the EU market and penalizing financial dealings with such centers with higher capital requirements. Lastly, pushing for the global regulatory floor was not considered incompatible with providing for a special and differential treatment for LDCs and other developing countries with small and immature financial systems which did not pose a systemic risk to international finance and which might not have the capacity to implement uniform standards adopted by the Organization of Economic Cooperation and Development (OECD) and the European Union (EU). This would help reduce the scope of financial actors 'gaming the system' or engaging in 'regulatory arbitrage' which was central to the build up of risks leading to the crisis. Too often, institutions were regulated on the basis of what they said they did rather than what they actually did.

Three further suggestions were made, including a new 'eagle eye' financial stability regulator, a stronger financial stability role for the European Central Bank (ECB), and a global prudential regulator. There was a need for a new 'systemic regulator' which had the capacity to have a ''bird's eye view'' of the financial system as a whole. This regulator also needed to be empowered to act to take corrective actions either by itself or through national level supervisors in the EU to guard against systemic risks which threatened financial stability. While a strong empowered regulator was ideal, the idea of a European Systemic Risk Council proposed by the de Larosiere Group was the next best solution. Secondly, as the purveyors of monetary policy, overseers of payments systems and lenders of last resort, central banks were in a unique position to identify and stem destabilizing developments in credit markets. Consequently, the ECB should be empowered to play a much stronger prudential oversight role to help maintain financial stability. Third and lastly, as the last global financial crisis had so starkly highlighted, systemic risk could arise from actions both inside and outside the EU common market. It was, therefore, critical to have a global financial stability watchdog in order to guard against the recurrence of a financial crisis of that scale. At the very least, such a regulator would oversee and co-ordinate the work of regional 'systemic regulators'. It was possible for a significantly reformed IMF or FSF or UN to take up this mantle, though there were certain advantages in setting up a completely new institution (Re-Define, 2011).

Having such systemic or financial stability regulators would help generate early warnings and reduce the occurrence of large financial crisis. One of the central lessons of the recent crisis was that having sound financial institutions was necessary, but not sufficient, for having a sound financial system, since inter-connections between institutions were also a major source of risk in the system. While a global regulator would be ideal, a pan EU systemic regulator at the very least was completely indispensable. Both the global and the regional regulators would need to have high legitimacy, sufficient resources and robust independence albeit with accountability. While firms should continue to be supervised at a national level, a close co-ordination of firm level or micro-prudential regulation standards was necessary both to ensure the effectiveness of system level macro regulations and also for the purpose of preventing regulatory

arbitrage and providing high and common levels of investor and consumer protection which were central to the smooth functioning of the single market. The consumer protection and investor protection and market integrity roles should ideally be performed by separate EU level institutions working in close co-ordination with each other and the respective national authorities (Re-Define, 2011).

Related Studies on Investment Regulation and FDI Inflow

A lot of studies had been done to evaluate the effects of regulation on investment, and particularly the flow of Foreign Direct Investment (FDI). However, almost all the studies were on sectoral regulation, rather than the regulation of investment in the economy as a whole. Some of these studies or researches are reviewed hereunder.

Colin, et al (2006), in their study, assessed the impact of regulatory governance on FDI in infrastructure projects in middle and low income economies. Using a dataset on private participation in infrastructure projects in developing countries for the period 1990 to 2002 by the World Bank, an econometric model was estimated in infrastructure sector. The determinants were grouped into control variables for economic policy and structural characteristics and infrastructure regulation variables. The selection of control variables was motivated by existing research on FDI, and the results were consistent with the empirical evidence on the key determinants of FDI. Three alternative measures of regulation quality were used in the empirical analysis. All were positively signed and statistically significant. FDI in infrastructure responded positively to the existence of an effective regulatory framework that provided regulatory creditability to the private sector. By implication, where regulatory institutions were weak and vulnerable to "capture" by the government (or the private sector), foreign investors might be more reluctant to make major commitments to large scale infrastructure projects in such developing countries. The main policy implication of the findings was the need for supporting capacity building and institutional strengthening for robust and independent regulation in developing countries.

Alberto *et al* (2003) in another study evaluated the commonly held view about the differences between continental European countries and other OECD economies, especially the United States: that the heavy regulation of Europe reduced its growth. An assembled data on regulation in several sectors of many OECD countries showed substantial and robust evidence that various measures of regulation in the product market, concerning in particular entry barriers, were negatively related to investment. The study implications were clear that regulatory reforms, especially those that liberalize entry, were very likely to spur investment.

Analyzing the relationship between entry regulation and infrastructure investment in the telecommunication sector in Europe offered mixed results on investments. Using a set of comprehensive data covering 180 fixed-line and mobile operators in 25 European countries over 10 years and employing a newly created indicator measuring regulatory intensity in the European countries, results of the study by Hans *et al* (2008) indicated that tough entry requirements discouraged investment. The study carefully treated the endogeneity problem of regulation by applying instrumental variables, and found out that tough entry regulation (e.g. unbundling) discouraged infrastructure investment by entrants, but that it had no effect on incumbents in fixed-line telecommunications. The study also discovered that a significant impact of entry regulation on investment in mobile telephony did not exist.

Investigating the theoretical effect of alternative regulatory policies on investment and innovational incentives in the telecommunications industry in the USA offered interesting insights. Technological convergence was leading to the creation of common platforms for historically distinct voice, data and video services. This would make a broad array of

software defined services available to consumers and businesses and lead to more efficient use of network resources. However, this process threatens existing inter-carrier compensation systems and other support mechanisms (U.S. Department of the Treasury, 2005).

Another concern on regulation was raised by the then US Federal Deposit Insurance Corporation (FDIC) Vice Chairman John M. Reich. In his testimony before the House Subcommittee on Financial Institutions and Consumer Credit, he stated that complex new laws and regulations could spell the end of small community banks. He opined that "The volume and complexity of existing banking regulations, coupled with new laws and regulations, may ultimately threaten the survival of USA community banks." Since the enactment of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) in 1989, banking and thrift regulatory agencies had promulgated 801 final rules as at then. According to him,"There were good and sufficient reasons for many of these rules... however, 801 regulatory changes over a 15-year period is certainly a lot for banks to digest, particularly smaller community banks with limited staff." Regulatory burden often affects smaller banks disproportionately. "New regulations have a greater impact on some community banks, especially small community banks (under $100 million in assets), than on larger institutions due to their inability to spread fixed and implementation costs over a large number of transactions." It was therefore not surprising that Reich is leading an interagency initiative, required by the Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA), to review all federal bank and thrift regulations in an effort to eliminate any regulatory requirements that are outdated, unnecessary or unduly burdensome (*Longley, 2004*).

A major strand running through most of these studies was the negative impact of regulation on investments, if not well managed or supervised. However, and as had been observed earlier, these had to do mainly with the regulation of the different sectors of the economy, and not the overall regulation of investment in general, or Foreign Direct Investment (FDI) in particular.

PRESENTATION, ANALYSIS, AND INTERPRETATION

Regulation of Investments in Uganda

The Investment Code Act, 1991, envisages under Section 6(a) that the Uganda Investment Authority (UIA) will, not only promote and facilitate, but also supervise, investments in Uganda. Through the promotional activities of UIA, the FDI into Uganda has been on the rise, though, up to 2010, it stuck below the US$1 Billion Dollar per year mark as shown in Table 1 below.

Table 1: FDI Inflows into Uganda 1990-2010

Period	1990-2000	2005	2006	2007	2008	2009	2010
FDI USD'm	82	380	644	792	729	816	848

Source: UNCTAD, WIR 2011

The number of firms investing in Uganda has, however, followed a cyclical pattern as seen hereunder in Table 2.

Table 2: Number of Licensed Investment in Uganda 1991-2010

Year	FDI	Year	FDI	Year	FDI	Year	FDI
1991	7	1996	225	2001	107	2006	434
1992	109	1997	186	2002	148	2007	369
1993	185	1998	101	2003	161	2008	381
1994	234	1999	67	2004	184	2009	314

Table 2: Contd.,							
1995	273	2000	89	2005	293	2010	323

Source: UIA, 2011

Further, and as can be seen from Table 3 below, the values of projects licensed by UIA continued to rise over the years, save for 2009 when it fell in response to the global financial melt-down.

Table 3: Values of Projects Licensed by UIA 2005-9 (USD'm)

Sector/Year	2005	2006	2007	2008	2009	Total
Agriculture, Hunting, Forestry and Fisheries	66.70	72.20	28.99	60.89	203.30	432.08 (5.52)
Community, Social and Personal Services	---	---	41.06	34.10	66.40	141.56 (1.81)
Construction	22.10	32.46	223.80	58.10	175.90	512.36 (6.55)
Electricity, Gas and Water	0.30	---	742.50	173.30	69.90	986.00 (12.60)
Financing, Insurance, Real Estate, Tourism & Business Services	75.50	351.60	109.90	380.90	309.84	1,227.74 *(15.68)*
Manufacturing	158.80	291.20	325.40	641.20	577.40	1,994.00 *(25.47)*
Mining & Quarrying	20.40	10.48	88.25	30.36	53.80	203.29 (2.60)
Transport, Communication and Storage	81.97	468.60	444.80	946.10	84.35	2,025.82 *(25.88)*
Wholesale & Retail Trade, Catering & Accommodation Services	---	---	218.30	55.90	31.04	305.24 (3.90)
TOTAL	**425.77**	**1,226.54**	**2,223.00**	**2,380.85**	**1,571.93**	7828.09

Notes: () = percent

Source: UIA, 2010

A review of Table 3 above shows that three categories of investment crossed the USD1 Billion cumulative investment mark within a five year period (2005 – 2009). These were the Transport, Communication and Storage group, Manufacturing group, and the Financing, Insurance, Real Estate, Tourism and Business Services group. Financial services were a major component of the last group. Also, it seemed deregulation influenced FDI inflow in the financial sector, as there was a curious relationship between Financial Services phenomenal growth matched by an equally increased growth in investment in Uganda in 2005/2006 following the lifting of the moratorium on licensing of new commercial banks in the country.

Thus, financial services are one of the major sources of investment in Uganda. By 2010, their planned Investment stood at US$ 1.677 billion with projected employment of 59,292 people *(UIA Database, 2010)*. However, the Private Sector Investor Survey 2009 of 63 Finance and Insurance entities demonstrated that the sector had actual investment values of US$ 540.6 million (UIA, 2010), and employed 9,962 people.

In spite of the remarkable successes of UIA with respect to investments in Uganda, as seen from the tables above, a review of its activities shows that its efforts are almost entirely geared towards investment promotion through trade fairs, missions, and investment conferences. Not much is done with respect to investment facilitation, and also almost nothing is being done to supervise or regulate the investments once they are licensed. UIA appears content to leave the supervision of

the investments, once they are established, to the regulators in the respective sectors of the economy in which the businesses operate; such as the Bank of Uganda (BoU) for the banking industry; the Insurance Regulatory Authority (IRA) for the insurance industry; the Capital Market Authority (CMA) for the capital market; and the Uganda Communication Commission (UCC) for the communication industry.

The emphasis in this paper is on the supervision of the financial system, particularly the banking industry, in Uganda.

Aims of Financial Regulation

The specific aims of financial regulation usually include enforcing applicable laws, preventing cases of market manipulation such as insider trading, ensuring competence of providers of financial services, protecting clients and investigating complaints, maintaining confidence in the financial system and reducing violations under the laws.

The financial system remains the engine of growth in any economy. The achievement of the aims of financial regulations will therefore positively impact on the economy as a whole. Banking, on its part, is the driving force of Uganda's financial sector, accounting for over 70 percent of its activities; with others (Insurance, Capital Market, and Pension) contributing to the balance. Within the banking industry, commercial banking accounts for 83 percent of the assets of the banking system; with 22 commercial banks, 393 branches, and 625 operational Automated Teller Machines (ATMs) countrywide, as at the end of 2010. Foreign owned (FDI) commercial banks dominate the industry, accounting for approximately 82 percent of the commercial banks in Uganda (18 out of 22); a development that is worrisome, given that the objectives of these foreign-owned banks could be at variance with the national economic objectives of Uganda.

The ownership structure, the number of branches, and the number of ATMs of the 22 commercial banks in Uganda, as at the end of 2010, are as presented in Table 1 below.

Table 4: Commercial Banks' Ownership and Number of Branches and ATMs in Uganda

	Bank	Ownership	No. of Branches	No. of ATMs
1	ABC Capital Bank Ltd	Foreign	2	0
2	Barclays Bank of Uganda Ltd	Foreign	48	71
3	Bank of Baroda (U) Ltd	Foreign	10	12
4	Bank of Africa Uganda Ltd	Foreign	21	18
5	Cairo International Bank Ltd	Foreign	3	3
6	Centenary Rural Dev. Bank	Local	36	71
7	Citibank Uganda Ltd	Foreign	1	1
8	Crane Bank Ltd	Local	13	46
9	Dfcu Bank Ltd	Foreign	26	24
10	Diamond Trust Bank Ug. Ltd	Foreign	18	15
11	Ecobank Uganda Ltd	Foreign	8	8
12	Equity Bank Uganda Ltd	Foreign	41	48
13	**FINA Bank Uganda Ltd	Foreign	5	4
`14	***Global Trust Bank (U) Ltd	Foreign	8	1
15	Housing Finance Bank Ltd	Local	11	12
16	KCB Uganda Ltd	Foreign	14	15
17	*National Bank of Commerce	Local	2	1
18	Orient Bank Ltd	Foreign	14	19
19	Stanbic Bank Uganda Ltd	Foreign	83	201
20	Standard Chartered Bank	Foreign	11	28
21	Tropical Bank Ltd	Foreign	8	14
22	United Bank for Africa Ltd	Foreign	10	14

Table 4: Contd.,				
	TOTAL		**393**	**625**

Source: Bank of Uganda 2011 Statistical Abstract

*The Banking License of National Bank of Commerce was withdrawn by BoU in 2012.

**Fina Bank was bought over by Guaranty Trust Bank (a Nigerian bank) in 2013.

*** The Banking Licence of Global Trust Bank was withdrawn in 2014.

- Another foreign bank, Imperial Bank (U) Ltd, commenced operations in 2011.

Instruments of Financial Sector Regulation in Uganda

Uganda's financial sector is fully liberalized and dominated by the banking industry. Since 1987, ambitious reforms have been implemented to increase competition and efficiency in the sector. In addition to the growth in the banking industry, Uganda has also witnessed increases in the activities of the capital market which have created a new avenue for raising capital, savings and investment in the country (UIA, 2010). Further, insurance and pension businesses have been on the increase in the country. However, the dominant role of the banking industry within the financial system in Uganda makes the country's central bank (Bank of Uganda) the leading regulator of its financial system.

A number of laws, regulations, and instruments govern the operations and supervision of financial institutions by the central bank in Uganda. The laws include the Bank of Uganda Act, 2000, (which provides the bases for the regulation and supervision of financial institutions in Uganda by the Bank of Uganda), the Financial Institutions Act, 2004, (which governs the regulation and supervision of banks and credit institutions by the Bank of Uganda), the Microfinance Deposit-Taking Institutions Act, 2003, (which governs the regulation and supervision of microfinance deposit-taking institutions by the Bank of Uganda), and the Foreign Exchange Act, 2004, (which governs the regulation and supervision of forex bureaus and money remitters by the Bank of Uganda).

The key regulations and guidelines employed by the BoU to regulate the banking industry in Uganda include the Financial Institutions Licensing Regulations (2005), the Financial Institutions Credit Reference Regulations (2005), the Microfinance Deposit-Taking Institutions Regulations (2004), the Foreign Exchange (Forex Bureaus and Money Remitters) Regulations (2006), the Financial Institutions (Revision of Minimum Capital Requirements) Instrument (2010), the Financial Consumer Protection Guidelines (2011), the Anti-Money Laundering Regulations (2009), and the External Auditors Regulations (2010). Other regulations in the pipeline include the Prompt Corrective Actions Regulations, Mergers, Acquisitions and Take-Overs Regulations, Internal Auditors Reporting Requirements Regulation and Finance Houses and Discount Houses Regulations.

To ensure effective supervision, financial institutions in Uganda are classified into Tiers 1 to 4. Tier 1 comprises commercial banks while Tiers 2 and 3 comprise Credit Institutions and Microfinance Deposit-Taking Institutions respectively. The operations of financial institutions under Tiers 1 to 3 are governed by the various regulations of the central bank (Bank of Uganda), while Tier 4 comprising other financial institutions such as Savings and Credit Cooperatives (SACCOs) and Micro Finance Institutions (MFIs) are currently outside the scope of BoU's supervision.

As stated above, the Bank of Uganda (BoU) is the main regulator of the financial system in Uganda. It is an autonomous body established to create a stable macroeconomic environment in order to enhance investment and economic

growth in the country. In fulfillment of the mandates of its enabling Act, the Bank provides financial services to private and public sector players, engages in the formulation and implementation of monetary policies to enhance macroeconomic stability; manages the nation's public debt; supervises or regulates the financial institutions and pension funds; issues currency notes and coins and; and maintains the country's external reserves.

Table 5: The Bank of Uganda (Bou) Uses the Following Regulatory Tools in Supervising the Banking Industry in Uganda

Regulation Tool	Policy
Cash Reserve Ratio (CRR)	10% of all demand deposits & 9% of time deposits to be placed with Bank of Uganda.
Minimum Capital Requirement (MCR)	Minimum capital requirement of Shs. 2 billion from 1st January 2001; Shs. 4 billion from 1st January 2003; Shs.10 billion from 1st March 2011; & Shs.25 billion from 1st March 2013.
Capital Adequacy Ratio (CAR)	Core Capital of 8% of Risk Adjusted Assets plus Risk Adjusted Off Balance Sheet items; and Total Capital of 12% of Risk Adjusted Assets plus Risk Adjusted Off Balance Sheet items.
Lending Limits	Maximum amount of credit exposure to any one borrower of 25% of capital; Maximum amount of aggregate credit exposure to insiders of 25% of capital; and Maximum aggregate credit of 800% of capital.
Maximum Liquidity Requirements (MLR)	Liquid assets of at least 20% of demand deposits plus 15% of time deposits.
Foreign Exchange Exposure Limit (FEEL)	25% of capital.

Apart from the above, the Bank of Uganda employs some other qualitative measures in the supervision of the financial system. These include requirements as to risk management, quality of directors and management, corporate governance, and disclosure requirements.

Developments in the Financial Sector

In the late 1980s, Uganda commenced the process of financial sector reforms that were anchored by the Bank of Uganda (BoU), but influenced by the International Monetary Fund (IMF) and the World Bank through the Policy Framework Papers (PFPs) which were the major instrument of economic reforms in Uganda as from 1988. Besides, bilateral donors such as the German Technical Cooperation (GTZ), Swedish International Cooperation for Development Agency (SIDA), and the Danish International Development Agency (DANIDA) also influenced the financial reform process in Uganda through the extension of technical support in the forms of provision of technical advisors, training of local staff, and granting of aids and loans (Bategeka and Okumu, 2010). The reforms have resulted in financial liberalization, increase in the number of banks and other operators, formalization of micro financing, establishment of Credit Risk Bureau (CRB), and emplacement of greater financial sector surveillance. As documented by Bategeka and Okumu (2010), the reforms were initiated in the late 1980s with a view to addressing the major misalignments in the financial sector that were believed to be impeding economic growth through the inefficient performance of the banking sector. These were principally the inefficient allocation of credit and the limited access to financial services by the larger population. Thus, the reforms had the bifurcate objective of efficiency and soundness in the banking sector, that is, achieving efficiency in financial intermediation on the one hand, and strengthening the banking sector through efficient and effective supervision by the central bank, on the other.

The financial sector reforms in Uganda have manifested in several facets. These included legal and regulatory reforms, privatization of financial institutions, interest rate liberalization, liberalization of exchange rate, capital account liberalization, commencement of Credit Risk Bureau activities, and the formalization of the informal financial sector through emphasis on micro financing.

In order to strengthen the financial regulatory framework, a number of laws were enacted in the course of the reforms. These included Bank of Uganda Act, 2000, the Micro-Finance Deposit-taking Institutions (MDI) Act, 2003, the Financial Institutions Act (FIA), 2004, and the Foreign Exchange Act, 2004. As stated earlier, the implementation of these laws have clearly segmented the financial institutions in Uganda into four tiers: Tier 1 for Commercial Banks; Tier 2 for Credit Institutions; Tier 3 for Micro-Finance Deposit-taking Institutions (MDIs); and Tier 4 for Other financial institutions (Micro-finance companies, SACCOs, etc). The Bank of Uganda (BoU) was established under the Bank of Uganda Act, 2000 to formulate and implement monetary policy directed at the economic objective of achieving and maintaining economic stability. It supervises the financial institutions under the first three tiers. It licenses and supervises the commercial banks and credit institutions under the Financial Institutions Act, 2004, and the Micro-Finance Deposit-taking Institutions (MDIs) under the Micro-Finance Deposit-taking Institutions (MDI) Act, 2003. The Tier 4 financial institutions, which include Micro-Finance Institutions (MFIs), Savings and Credit Cooperatives (SACCOs), etc, are neither licensed under these laws, nor supervised by the Bank of Uganda (BoU); but are left under the Companies' Act, 1961, Money Lenders' Act, 1952 and the Ministry of Finance, Planning and Economic Development. The Foreign Exchange Act, 2004, is also operationalized by the Bank of Uganda (BoU) which licenses the operators of foreign exchange (Foreign Exchange Bureaus and Money Remitters). The Act provides for the exchange of foreign currencies in Uganda, as well as the making of international payment transfers of foreign exchange in and out of the country.

Next, and as part of the reform, some of the financial institutions owned by the Government of Uganda were privatized. Under this arrangement, the government sold its stake in three commercial banks in Uganda- Uganda Commercial Bank finally in 1999, Bank of Baroda in 2002, and DFCU Bank in 2004. As discovered by Bategeka and Okumu (2010), the exercise was carried out to strengthen the financial system, rather than to raise revenue for the government.

Further, and as a component of the financial sector reform, the government commenced the process of interest rate liberalization in 1989 by adjusting the nominal interest rates to match the rising inflation. This was followed in July 1994 by the full liberalization of the interest rate structure, thus allowing the rates to be determined by the market forces; only to be indirectly influenced by the Treasury Bill rates of the Bank of Uganda.

The government also liberalized the exchange rate system over time. This commenced in 1990 with the legalization of the foreign exchange bureaus and the adoption of the foreign exchange auction system. It was then completed in 1994 with the elimination of the restrictions on the country's current account transactions to bring the system in conformity with Article VIII of the International Monetary Fund (IMF) Agreement. In 1997, the government went further to liberalize the country's capital account. This allowed the citizens and residents of Uganda to hold foreign currency denominated assets, operate foreign currency denominated accounts, and to bring in and take out capital for investment.

Finally, in order to tackle the twin problems of limited access to credit and the rising loan delinquency in the country's financial system, the central bank launched the operation of Credit Risk Bureaus (CRB) on 3rd December, 2008

with Compuscan as the first (and still the only) CRB in Uganda. This was meant to sanitize the credit market by ensuring that credits are given only to customers with good loan repayment records. It thus became an offence for a bank or its officer to extend any credit facility to a customer without first inquiring about his/her/its credit records with the Bureau. However, there has been the concern that as good intentioned as this policy may be, it may end up further constraining the availability of credit in the system (Bategeka, and Okumu, 2010).

FINDINGS

Some findings were made in the course of the study. These included the following:

Non-Supervision of Investments by the Uganda Investment Authority (UIA)

The UIA is envisaged under Section 6(a) of the Investment Code Act, 1991, not only to promote and facilitate, but also to supervise investments in Uganda. While UIA has had impressive records in attracting investments into the country, it had not done well with respect to facilitation. The situation was even worse with the supervision of investments in Uganda where the Authority seemed to have abandoned its statutory responsibility in that regard, and had left the supervision almost entirely to the sectoral regulators, like Bank of Uganda (BoU), Insurance Regulatory Authority (IRA), Capital Markets Authority (CMA), and Uganda Communication Commission (UCC).

Strong supervision of the Financial System

As at the end of 2010, there were 22 licensed commercial banks in Uganda, with 393 bank branches. The main law governing banks in Uganda was the Financial Institution Act, 2004, which categorized financial institutions into eight classes, a to h. Class a of the Financial Institutions were the commercial banks which were authorized to hold checking, savings and time-deposit accounts for individuals and institutions in local as well as international currencies. They were also authorized to buy and sell foreign exchange, issue letters of credit and make loans to depositors and non-depositors. Classes b to h were post office savings banks, merchant banks, mortgage banks, credit institutions, acceptance houses, discount houses, and finance houses respectively.

As earlier observed, the banking industry was the most dominant within Uganda’s financial system, and commercial banking the most dominant within the country’s banking industry. The Bank of Uganda (BoU) was responsible for supervising the activities of all the licensed commercial banks operating in the country. It had effectively used a number of regulatory instruments and tools to achieve its regulatory aims,, as earlier discussed Thus, the banking system in Uganda was well regulated under the Bank of Uganda (BoU).

High Level of Capitalization

The Bank of Uganda ensured that the banking industry was well capitalized, through periodic reviews of the minimum capital requirements in line with the inflationary and global trends, especially for the commercial banks. In November 2010, it directed all commercial banks in Uganda to raise their minimum capital to Ugx:10 billion (then approximately US$4.34 million) by March 2011, and to Ugx:25 billion (then approximately US$11 million) by March 2013. Any new commercial bank entering the Ugandan market effective November 2010, was to have a minimum capitalization of Ugx:25 billion.

Under-Banking of the Rural Areas

Most of the banking activities in Uganda are concentrated around Kampala, the country's capital and other large

towns, leaving the residents of other areas at the mercy of the informal financial sector. Like in most other developing economies, the activities of banks have the most profound impacts on access to financial services in Uganda. With the lifting of the moratorium on the licensing of new commercial banks in July 2007, many foreign banks established presence in Uganda. This was complemented by the increase in the number of branches of the existing banks. However, these developments occurred mainly in Kampala and a few other cities. Thus, a greater chunk of the population living in rural areas were still left unbanked or under banked, and at the mercy of money lenders and other informal lending institutions. These led to what has been identified as the paradox of many banks that are not willing to lend to the people on the one hand, and many people that have unmet high demand for credits on the other hand (Bategeka and Okumu, 2010),. Indeed, the Daily Monitor Newspaper (Monday, March 26, 2012) reported that 62 percent of the entire population of Uganda still had no access to financial services, while the number holding accounts in banks was four million or 33 percent of the twelve million that were bankable.

Foreign Domination of the Financial System

Most commercial banks were foreign owned (18 out of 22). These included major international banks such as Stanbic (South Africa), Citibank (USA), Barclays (United Kingdom), Standard Chartered (United Kingdom) and United Bank for Africa (Nigeria). Thus, only 4 out of 22 commercial banks (18%) were local, while 18 (82%) were foreign owned. Also, in terms of branch network, the locally owned banks had 62 of the total number of 393 branches (16%), while the foreign owned banks had 331 of the number (84%). These clearly showed the dominance of commercial banking in Uganda by foreign entities. However, the local institutions dominated the credit institutions and microfinance deposit-taking institutions segments of the Ugandan banking industry.

Relationship between Financial Services and Growth in Investment

There had been a continuous deregulation of the financial system in Uganda since the late 1980s. It seemed the deregulation influenced FDI inflow into the financial sector. There existed a curious relationship between financial services phenomenal growth and an equally matched growth in investment in Uganda since 2005/2006 following the lifting of the moratorium on the licensing of new commercial banks in the country. This phenomenon led to the suspicion that there existed a relationship between regulation and FDI inflow in Uganda. Financial Services was one of the most phenomenal growth sectors of Uganda’s economy in general, and in investments and employment in particular. Up to 2010, the growth rates were mainly double digit with the highest growth recorded in 2005/2006 following the lifting of the moratorium on licensing of new commercial banks.

Thus, financial services were one of the major sources of investment in Uganda. By 2010, its planned investment stood at US$ 1.677 billion with projected employment of 59,292 people *(UIA Database, 2010).* However, the Private Sector Investor Survey 2009 of 63 Finance and Insurance entities demonstrated that the sector had actual investment values of US$ 540.6 million (UIA, 2010), and employed 9,962 persons, as at that year.

RECOMMENDATIONS

Regulation of Investments by UIA

The Uganda Investment Authority (UIA) should live up to its statutory responsibility of supervising investments in Uganda, as provided under Section 6(a) of the Investment Code Act, 1991, if the country is to realize the full benefits of the licensed investments. While immense benefits exist for different sectoral supervisions, there are benefits to the

economy as a whole in the over-all, and second-level, supervision of investments by the Authority as envisaged by the Act. While the sectoral supervision focuses on the operations of investors in, and the benefits to, a particular sector, the over-all investment supervision will address the benefits of the investment to the entire economy, relating them to the very essence of their establishment.

It is possible for the activities of an FDI to impact positively on a sector of the economy, while hurting some other sectors or indeed the whole economy. Such conflicts can be resolved if UIA is effectively involved in the supervision of investments, in addition to the efforts of the regulators of the respective sectors.

Stimulation of Local Investments in the Banking Industry

Uganda has had an impressive record of attracting foreign investments; with over $4b FDI inflows, over 4,000 licensed projects, and over 440,000 new jobs since the investment body was set up in 1991, up to 2010. A review of the statistics of projects licensed by UIA revealed the emerging dominance of Ugandan investors. For instance, Ugandans topped the list of planned investments, with new jobs and projects licensed in the quarter that ended in September 2008. The UIA report for that period indicated that planned investment by Ugandans was worth Shs167.9 billion (then $98.8 million equivalent), with 17 projects and 959 jobs to be created. This happened in spite of a slight drop in the total planned investment of $297 million (the equivalent of Shs504.6 billion), down from $369 million (then equivalent of Shs627.3 billion) recorded in the previous quarter. While releasing the report at the Media Centre on October 8, 2008, the then Chairman of Board UIA Mr. Patrick Bitature remarked that "For a country to attract more FDI, citizens need to feel confident and invest in their own country. This is a plus seeing more Ugandans investing and this will attract more FDI."

Unfortunately, the positive picture painted above did not hold for the financial system in Uganda. Commercial Banking remained the driving force of Uganda’s financial sector, accounting for 83 per cent of the assets of the Banking system. As at the end of 2010, there were 22 commercial banks with 393 branches and 625 operational Automated Teller Machines (ATMs) countrywide; with foreign owned commercial banks (FDI) accounting for 18 (82%) of the number. Thus, the deregulation of the industry in the past decades had even reinforced the position against local investors; with almost all the subsequently licensed commercial banks being foreign owned. Given that the financial sector, itself, is the driving force of the entire economy, it is considered risky to leave such a vital sector virtually under the control of foreign investors, whose objectives may be incongruent with those of the host economy.

It is recommended, therefore, that the financial system be reformed to encourage the local investors to increasingly participate in it. There may be the need to set a different, and lower, minimum capital requirements for the establishment of commercial banks by local investors, as is done in some Sub-Saharan African countries such as Zambia. This will bring the critical financial industry, and indeed the whole Ugandan economy, substantially under the control of locals.

Banking Reform to Enhance Financial Penetration

The rural areas in Uganda were largely unbanked; hence creating a financial gap. Most of the banking activities were concentrated around Kampala, the country's capital and other large towns, thereby leaving about 62 percent of the entire population of Uganda (mostly resident in the rural towns) with no or limited access to financial services. There was, therefore, the need to attract banking to the rural areas of the country.

To achieve the above objective, the Bank of Uganda (BoU) was enjoined to consider the adoption of a Rural

Banking Scheme that would encourage the banks to open branches in the rural areas. This could be for a period of time, say ten years. For instance, tax rebates and the bundling of urban and rural branches approvals by BoU, could be used to achieve this. The latter strategy was particularly effective in driving financial penetration in Nigeria in the 1980s and early 1990s.

Area for Future Research

Financial Services is one of the most phenomenal growth sectors of Uganda's economy. Up to 2010, the growth rates were mainly double digit with the highest growth recorded in 2005/2006 following the lifting of the moratorium on licensing of new commercial banks.

As has been highlighted earlier, the financial services were also one of the major sources of investment and employment in Uganda. By 2010, its planned investment stood at US$ 1.677 billion with projected employment of 59,292 people *(UIA Database, 2010).* However, the Private Sector Investor Survey 2009 of 63 Finance and Insurance entities demonstrated that the sector had actual investment values of US$ 540.6 million (UIA, 2010), and employed 9,962 persons, as at that year. Even with such actual figures, the financial services industry still remained a significant sector of the Uganda economy.

CONCLUSIONS

The study discovered the existence of a curious relationship between the phenomenal growth of financial services and an equally matched increase in investment in Uganda since 2005/2006 following the lifting of the moratorium on the licensing of new commercial banks in the country. This phenomenon led one to suspect that a relationship existed between financial regulation and FDI inflow into Uganda that called for further quantitative analysis; and this was recommended as an area for future research.

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